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TAX·FEATURES

Tax Foundation Celebrates with CSE Foundation in Washington; Bentsen and Roderick Featured at Annual Dinner in New York

Front Burner

by Bob Packwood
U.S. Senator, Oregon

Sequester May Be Best Medicine For Broken Budget

While somewhat overshadowed by the battle over reducing the capital gains tax burden, it may turn out that the most significant event in this year's budget debate is sequestration — Gramm-Rudman's automatic spending control procedure. Because Congress was unable to reduce the deficit below the $110 billion trigger level, the President issued a sequester order on October 16, reducing the projected 1990 deficit to $100 billion as required by law.

With capital gains temporarily slipping out of the limelight, the sequester has become the focus of partisan debate. Each side accuses the other of being responsible for "deep and arbitrary" budget cuts. Some legislators say we should do whatever it takes to cancel the sequester, even if it means higher taxes. While a sequester is certainly not the ideal way to resolve this year's budget dispute, there are reasons to believe that the fiscal discipline of a sequester is the medicine we need to cure the budget process.

For all its drawbacks, a sequester is real deficit reduction. Instead of budget gimmicks, accounting tricks, phony cuts, and "revenue enhancements," a sequester would reduce spending levels by a fixed percentage in eligible spending programs. In other words, unlike most deficit reduction packages, sequestration would actually reduce the deficit.

(See SEQUESTER on page 2)

Ed. Note: Readers will notice that we have moved the Front Burner up front and changed it to a guest editorial format. TF President Wayne Gable will address readers in a new column as Tax Features *expands and improves. We encourage responses from others in the fiscal policy arena.*

Tax Foundation's friends and supporters gathered at the Mayflower Hotel in Washington November 1 to celebrate the foundation's continuation under the aegis of the Citizens for a Sound Economy Foundation.

After remarks by President Wayne Gable and Co-Chairmen James Q. Riordan and James C. Miller III, several distinguished guests came to the podium. Senator John McCain said of the Tax Foundation, "Without your expertise and knowledge, I don't think we'd do our jobs half as well as we do." Congressman Bill Archer added, "I'm excited for the future of this partnership of Citizens for a Sound Economy Foundation and the Tax Foundation, and I welcome your input in the years ahead." Congressmen Charles Stenholm, Ed Jenkins and Chris Cox also spoke highly of the two organizations.

Conversation focused on the upcoming annual conference in New York City. Scheduled for November 29 at the Halloran House, the conference will start at 1:00 p.m. Kendyl Monroe of Sullivan & Cromwell will chair the first panel on "Revenue Estimating: Evolving Toward Conflict or Consensus?" Speakers will include Gail Fosler from The Conference Board, Kathleen O'Connell of the Congressional Budget Office, Bernard Schmitt from the Joint Committee on Taxation, and John Wilkins from Treasury.

David Milton, retired, formerly of Shell Oil, will lead the afternoon's second panel on the topic: "Is International Taxation Becoming Backdoor Protectionism?" The panelists: William Modahl of Digital Equipment, Phillip Morrison from the Department of the Treasury, and Alan Reynolds of Polyconomics, Inc.

At the annual dinner that evening, the Tax Foundation will confer two Distinguished Service Awards. Recognized for outstanding public sector contributions will be the current Senate Finance Committee Chairman, The Honorable Lloyd Bentsen. At the same time, David Roderick, Retired Chairman and Chief Executive Officer, USX Corporation, will be honored for his private sector contributions.

Hon. Lloyd Bentsen

David Roderick

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Tax Foundation Principles of Taxation

Ed. Note: The Tax Foundation believes it is important to set forth an explicit and consistent set of principles to guide policy discussion. First printed in Federal Tax Policy Memo *last June, we reprint them here to emphasize that they guide our editorial decisions.*

The first five principles focus on tax certainty and taxpayers' ability to comply. Principles six through nine relate to tax policy and economic efficiency, both domestic and international, and principle ten applies one through nine to the whole federal system.

1) A good tax system requires informed taxpayers. It should be clear to the taxpayer who and what is being taxed and how tax legislation is enacted.

2) The tax system should be as simple as possible, easy to understand, and easy to comply with. Compliance expense is a cost to society, and complicated taxation undermines voluntary compliance.

3) Stability is important. The tax law should not change continually. Regulations should be issued promptly after legislation is enacted but frequent change makes this impossible.

4) Changes in the tax law should not be retroactive. Taxpayers should be able to rely with confidence on the law as it exists when they enter a transaction.

5) Tax legislation should be based on sound legislative procedures and careful analysis. There should be open hearings with full opportunity to comment on legislative and regulatory proposals. Revenue estimates should be fully explained.

6) The primary purpose of taxes is to raise needed revenue, not to micromanage the economy with subsidies and penalties. The tax system should aim for neutrality in economic decision making and minimize distortions of the free market. The tax system should not favor consumption over savings and investment (or vice versa).

7) It makes a difference how large a share of GNP is taken by the government in taxes because the taxpaying private sector generates the wealth that determines our standard of living. It makes a difference how we define the tax base because we burden the activities included in the tax base.

8) Taxes should be broadly based and rates of tax should be moderate at all points.

9) As we live in a global marketplace, the U.S. tax system must be competitive with those of other industrialized nations. The U.S. tax system should not impede the free and fair flow of goods, services and capital. It should not penalize imports, exports, U.S. investment abroad, or foreign investment in the U.S.

10) State taxes are an important factor in our federal system. The same general policies that apply to federal taxes should also apply to state taxes. Federal and state tax systems should be harmonized to the extent possible.

(SEQUESTER from page 1)

Yes, a sequester would be bitter medicine. According to current estimates, a sequester would reduce 1990 spending levels for eligible non-defense programs by 5.3 percent and spending levels in defense by 4.3 percent. In terms of the overall budget, a sequester would limit 1990 spending to $1.174 trillion, an increase of only 2.7 percent over 1989 levels.

Many programs would receive no increase in their budgets whatsoever. In a town where regular spending increases are thought of as a Constitutional right, not receiving an increase is equated with having your budget cut. Some programs would actually receive less money in 1990 than they got in 1989. Defense spending, for instance, would actually decline compared to the previous year.

Perhaps the greatest objection to a sequester will result from how certain politically popular programs are affected. Reductions in proposed spending levels for drug enforcement, AIDS research, air traffic control, and military manpower will doubtlessly generate concern among policymakers. Fortunately, however, the Gramm-Rudman law provides legislators and the president opportunities to adjust a sequester. As such, if we can avoid excessive partisanship, we can increase spending levels in high-priority areas so long as we are willing to reduce spending in less important parts of the budget.

Notwithstanding the drawbacks of a sequester, we should not overlook the benefits. Assuming the economy maintains its strength, we will bring the deficit down to $100 billion, the lowest level since 1981 and less than half the level it was as recently as 1986. Perhaps more importantly, a sequester this year will dramatically assist future deficit reduction efforts since it would lower the baseline growth of federal spending. For instance, a $16 billion sequester this year would save taxpayers $22 billion next year and $128.5 billion in total savings over the next five years.

The future savings of a sequester are important because Gramm-Rudman requires that the budget be balanced by 1993. Budget and accounting gimmicks will not do the trick. Both the Senate- and House-passed deficit reduction bills yield little if any long-term savings. A sequester may not produce all the savings needed to reach the $64 billion deficit target for fiscal year 1991, but it will bring us close enough to make any discussion of economically destructive tax increases unnecessary.

The President has rightfully stated that he would be unwilling to repeal the sequester unless Congress was willing to come up with a comparable amount of real savings. Perhaps Congress will pass legislation fulfilling the President's requirements. Should that fail to happen, however, a full-year sequestration would be the preferable outcome.

While a sequester would signal a failure of the budget process, we should hesitate before rushing to somehow nullify the procedure. The authority already exists to make needed adjustments to protect vital programs. Because real deficit reduction is so important, however, it may be time to grit our teeth and let the bulk of the sequester stand.

"Soaking the Rich" No Solution to Government Revenue Shortfalls

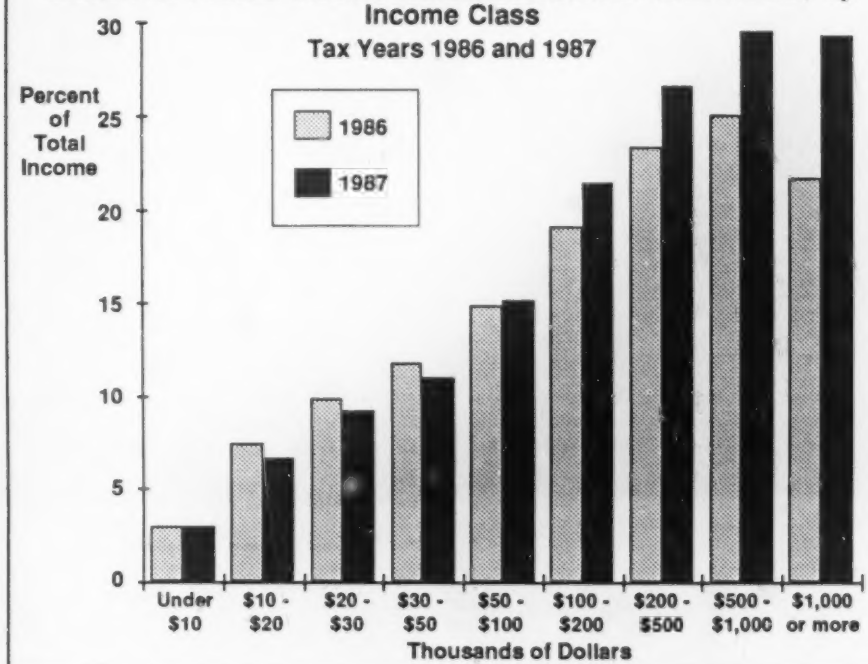
When lawmakers face politically painful revenue decisions, some of them cling to the fond hope that higher income taxes on the wealthy will solve all their problems. They fervently believe that the additional revenue could erase the budget deficit and fund more programs. Alas, if the solution were that easy, it would have been implemented long ago.

Exhibit A. Additional Number of Days the Federal Government Could Run By Taxing Top-Income Brackets at 100 Percent
Tax Year 1987

Adjusted Gross Income Class	Number of Returns	Percent of all Returns	Adjusted Gross Income ($Bil)	Taxable Income ($Bil)	Income Tax Paid ($Bil)	Additional Revenues If Taxed at 100% ($Bil)	Number of Days Federal Government Could Run*
$1 Million or more	36,299	0.03%	$ 87.2	$ 75.5	$ 25.5	$ 50.0	17.1 Days
$500 Thousand or more	113,390	0.11%	$ 139.1	$ 119.8	$ 40.8	$ 79.0	27.1 Days
$200 Thousand or more	545,177	0.51%	$ 263.1	$ 221.3	$ 99.5	$ 121.8	41.7 Days

* 1988 total federal outlays equaled $1,064.0 billion or $2.92 billion per day.
Source: Tax Foundation computations based on Statistics of Income, Internal Revenue Service, U.S. Department of the Treasury.

Exhibit B. Federal Income Tax as a Percent of Total Income by Income Class
Tax Years 1986 and 1987



Tax Year	$0 to $10	$10 to $20	$20 to $30	$30 to $50	$50 to $100	$100 to $200	$200 to $500	$500 to $1,000	$1,000 or More
	Income Class (In thousands of dollars)								
	Tax as a Percent of Total Income								
1986	2.9	7.5	9.9	11.8	14.9	19.2	23.4	25.1	21.7
1987	2.9	6.7	9.3	11.0	15.2	21.4	26.6	29.5	29.3
	Change from 1986 to 1987								
'86 to '87	-	-0.8	-0.6	-0.8	+0.3	+2.2	+3.2	+4.4	+7.6

* Based on Internal Revenue Service standardized income concept and actual tax returns for 1986 and 1987.

The Tax Foundation's ongoing research into tax collections at various income brackets continues to show this "soak the rich" tactic to be a false hope. Exhibit A at left illustrates how much additional tax revenue could be generated at the higher end of the income scale by assuming the most extreme example of taxation — total confiscation of all taxable income — a 100 percent tax rate.

At the top of the income scale, those with a million dollars or more in annual income, there are simply not enough taxpayers to generate a significant increase in revenue. These top earners numbered 36,299 according to 1987 individual income tax data (latest available) and represented just 0.03 percent of all taxpayers. Their adjusted gross income (AGI) totaled $87.2 billion with a taxable income of $75.5 billion, and they paid $25.5 billion in income tax for an average effective tax rate of 29.3 percent on AGI. If the federal government had simply confiscated all of this group's taxable income, Uncle Sam would have collected an extra $50 billion — enough to run the government for 17 days at 1988 outlay levels.

Two and a half weeks goes by quickly, so the government could reach even deeper into the top brackets by appropriating 100 percent of all taxable income from the $500,000-and-over group. This confiscation

(See SOAKING THE RICH on page 4)

Tax Features

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(SOAKING THE RICH from page 3)

could theoretically have netted an additional $79 billion, sufficient revenue to pay its bills for 27 days, but even four free weeks won't put Uncle Sam's accounts in the black.

Taking it a step further, commandeering all the taxable income of $200,000-and-above earners could have brought in $121.8 billion from 545,000 taxpayers, enough to run the federal government for one month and 11 days. While this tactic is now generating more money, it is also moving down from the very rich to families who are merely well-off.

To generate substantial new revenue, the government would have to reach far down the income scale, a move that would undoubtedly raise stiff political opposition. To impose higher tax rates on just the top ten percent of taxpayers, for example, would affect returns starting at $54,700 (including joint returns), an income level which certainly does not qualify for "fat cat" status.

TRA'86 No Boon to Top Earners

The often heard argument that the Tax Reform Act of 1986 provided upper-income individuals with a bountiful tax cut at the expense of the middle- and lower-income classes quickly fades when examining the actual 1987 tax return data. Total individual income tax receipts reached $371 billion in 1987, a modest 1 percent or $4 billion increase over 1986 collections. Despite this increase, the average amount of income tax paid per taxpayer actually declined from $4,374 to $4,280. Individuals earning $50,000 or more paid $24 billion more in income tax in 1987, while the under-$50,000 income group experienced a tax reduction of $20 billion. Since the two-earner median family earned $44,536 in 1987, the "middle-class" clearly benefited from this $20 billion tax reduction.

Exhibit B on page 3 uses tax return data to detail the changes in the income tax distribution by income class between 1986 and 1987. Total income tax as a percentage of income remained unchanged at 13.2 percent. However, income classes under $50,000 showed a lower effective tax rate for 1987 and those classes over $50,000 showed a higher effective tax rate. In fact, the greatest increase was for the $1-million-or-more income class where the effective tax rate increased from 21.7 to 29.3 percent.

It is easy to overlook the fact that upper-income groups are now absorbing more of the federal income tax burden because these facts rarely surface in the tax burden debate. Some policymakers will no doubt continue to offer "soaking the rich" as a panacea. In reality, any significant tax increases would end up soaking the average American as well.

Fiscal Notebook

Conferences

- The National Taxpayers Union will sponsor the first National Taxpayers Conference. Speeches and workshops on legislative strategies to limit taxes. December 9-10 in St. Louis. Call 202-543-1300.
- The Tax Executives Institute's conference, EC 1992: A Single Market, will cover tax and trade implications of European unification. December 10-12 in Washington, D.C. Call 202-638-5601.
- The International Tax Institute will hold a conference in New York City on the CFC Netting Rule. Speaker: Charles Brezak. Call 212-407-3398.

Publications

- The Institute for Research on the Economics of Taxation has released *U.S. Foreign Tax Policy and the Global Economy: New Directions for the 1990s.* A compilation of papers on policy barriers to competition abroad. $5.95. Call 202-347-9570.
- The Urban Institute recently released *Chartbook on the Medically Uninsured.* Who among the medically uninsured would be affected by legislation requiring employers to provide group health insurance? 8/89, 20 pp., $7.95. Call 301-459-3366.
- The American Council for Capital Formation has issued a brief special report entitled *The Importance of Capital Gains Tax Rates to Individual and Corporate Investors.* 9/89, 2 pp., free. Call 202-293-5811.

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